SECURITIES AND EXCHANGE COMMISSION

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Private Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The Commission is publishing for comment new rules under the Investment Company Act of 1940 to implement provisions of the National Securities Markets Improvement Act of 1996 that apply to private investment companies. The proposed rules would define certain terms for purposes of the new exception from regulation under the Investment Company Act for private investment companies whose investors are all highly sophisticated investors, termed ''qualified purchasers.'' The proposed rules also would address certain transition issues related to existing private investment companies that have no more than 100 investors and certain other matters related to private investment companies.

DATES: Comments must be received on or before February 10, 1997.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6–9, Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–30–96; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters also will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: David P. Mathews, Senior Counsel, Nadya B. Roytblat, Assistant Office Chief, or Kenneth J. Berman, Assistant Director, at (202) 942–0690, Office of Regulatory Policy, Division of Investment Management, Stop 10–2, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed new rules 2a51–1, 2a51–2, 2a51–3, 3c–1, 3c–5, 3c–6 and 3c–7 under the Investment Company Act of 1940 [15 USC 80a] (the ''Investment Company Act'' or ''Act'').

Table of Contents

Executive Summary
I. Background
A. Qualified Purchaser Funds
B. Amendments to Section 3(c)(1)
C. Other Directed Rulemaking
II. Rules Relating to Qualified Purchaser Funds
A. Investments
1. Definition of Investments
a. Securities
b. Real Estate
c. Commodity Interests
d. Cash and Cash Equivalents
e. Request for Comment
2. Determining the Amount of Investments
a. Value of Investments
b. Deductions from Amount of Investments
i. Certain Indebtedness
ii. Other Payments
iii. Request for Comment
3. Jointly-Held Investments
4. Investments Held by Certain Corporate Affiliates
5. Good Faith Reliance on Certain Documentation
B. Definitions of Beneficial Ownership
1. The Grandfather Provision
2. The Consent Provision
C. Conforming Rule
D. Non-Exclusive Safe Harbor for Certain Section 3(c)(7) Funds
III. Other Rules for Private Investment Companies
A. Transition Rule for Section 3(c)(1) Funds
B. Investments by Fund Employees
C. Certain Transfers
IV. General Request for Comment
V. Cost/Benefit Analysis
VI. Summary of Regulatory Flexibility Analysis
VII. Statutory Authority
Text of Proposed Rules

Executive Summary

The Commission is proposing rules to implement certain provisions of the National Securities Markets Improvement Act of 1996 (the ''1996 Act''), which was signed into law by President Clinton on October 11, 1996. The 1996 Act, among other things, added section 3(c)(7) to the Investment Company Act to create a new exclusion from regulation under the Act for private investment companies that consist solely of highly sophisticated ''qualified purchasers'' owning or investing on a discretionary basis a specified amount of ''investments'' (''section 3(c)(7) funds''). The 1996 Act also amended section 3(c)(1) of the Investment Company Act, which excludes from regulation under the Act private investment companies with 100 or fewer ''beneficial owners'' (''section 3(c)(1) funds''). Reflecting a relationship between section 3(c)(1) and new section 3(c)(7), the 1996 Act contains provisions that permit an existing section 3(c)(1) fund to convert into a section 3(c)(7) fund or invest in a section 3(c)(7) fund as a qualified purchaser, subject to certain requirements designed to protect the section 3(c)(1) fund's existing beneficial owners.

The 1996 Act requires the Commission to prescribe rules defining the terms ''investments'' and ''beneficial owner'' relevant to the new provisions by April 9, 1997. Other changes to the provisions of the Investment Company Act relating to private investment companies require Commission rulemaking as well. The Commission is proposing for public comment new rules under the Investment Company Act that would:

- Define the term ''investments'' for purposes of the qualified purchaser definition;
- Define the term ''beneficial owner'' for purposes of the provisions that permit an existing section 3(c)(1) fund to convert into a section 3(c)(7) fund or to be treated as a qualified purchaser;
- Address certain interpretative issues under section 3(c)(7);
- Permit certain section 3(c)(1) funds to rely on the pre–-1996 Act provisions of section 3(c)(1) rather than restructure their existing relationships with investors;
- Permit knowledgeable employees of a section 3(c)(1) or a section 3(c)(7) fund (referred to collectively in this Release as ''private funds''), and knowledgeable employees of affiliates of these funds, to invest in the fund; and
- Address transfers of securities in a private fund when the transfer was caused by legal separation, divorce, death, and certain other involuntary events.

I. Background

Section 3(c)(1) of the Investment Company Act excludes from regulation under the Act certain private investment companies ''whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons.'' [1] A wide variety of investment vehicles rely on section 3(c)(1), ranging from small groups of individual investors, such as investment clubs, to venture capital and other investment pools designed primarily for sophisticated investors.[2]

[1] 15 U.S.C. 80a–3(c)(1). In addition, the section 3(c)(1) fund must be an issuer that ''is not making and does not presently propose to make a public offering of its securities.''

[2] *See* Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment

A. Qualified Purchaser Funds

In 1992, the Commission concluded that the 100-investor limit, while reasonably reflecting the point beyond which federal regulatory concerns incorporated in the Investment Company Act are raised, may place unnecessary constraints on investment pools that sell their securities exclusively to sophisticated purchasers.[3] The Commission recommended that Congress amend the Investment Company Act to create an alternative exclusion for investment companies whose securities are owned exclusively by sophisticated investors.

Congress implemented this recommendation in the 1996 Act. New section 3(c)(7) of the Investment Company Act creates an exclusion for investment companies whose investors consist solely of ''qualified purchasers.''[4] New section 2(a)(51)(A) of the Investment Company Act defines the term qualified purchaser as (i) any natural person who owns not less than $5 million in investments,[5] (ii) a family-owned company (''Family Company'') that owns not less than $5 million in investments,[6] (iii) certain trusts,[7] and (iv) any other person (*e.g.*, an institutional investor) that owns and invests on a discretionary basis not less than $25 million in investments.[8] The 1996 Act directs the Commission to prescribe rules defining the term ''investments'' for purposes of determining whether a prospective investor in a section 3(c)(7) fund (''prospective qualified purchaser'') meets the $5 million/$25 million thresholds.[9]

Section 3(c)(7) includes a ''grandfather'' provision that allows an existing section 3(c)(1) fund to convert into a section 3(c)(7) fund (''Grandfathered Fund''). The outstanding securities of a Grandfathered Fund may be beneficially owned by as many as 100 persons who are not qualified purchasers, provided that these persons acquired their investment in the Grandfathered Fund on or before September 1, 1996.[10] The grandfather provision is designed to allow an existing section 3(c)(1) fund wishing to avail itself of the new section 3(c)(7) exclusion to continue its existing relationships with investors who are not qualified purchasers.[11]

The grandfather provision requires the Grandfathered Fund, prior to the conversion, to provide each beneficial owner of its securities (i) notice of the fund's intention to become a section 3(c)(7) fund and (ii) an opportunity to redeem such owner's interest in the fund.[12] This provision is designed to enable an investor in an existing section 3(c)(1) fund to dispose of an investment, without penalty, if the investor does not choose to continue its investment in a private investment company that no longer will be limited to 100 investors.[13] The 1996 Act directs the Commission to define the term ''beneficial owner'' for this purpose.[14] The 1996 Act also requires an existing section 3(c)(1) fund that wishes to become a qualified purchaser to obtain the consent of the beneficial owners of its securities and certain other persons (the ''consent provision'').[15]

The Commission is proposing a rule under the Investment Company Act to define the term ''investments'' for purposes of the qualified purchaser definition. The Commission also is proposing rules to define the term ''beneficial owner'' for purposes of the grandfather and the consent provisions, and to address other transitional and interpretative issues related to section 3(c)(7).

B. Amendments to Section 3(c)(1)

To prevent circumvention of the 100-investor limit, section 3(c)(1)(A) (the ''look-through provision'') requires, in some instances, that a fund seeking to rely on the provision ''look through'' certain companies (*e.g.*, corporations, partnerships and other investors that are not natural persons) that hold its voting securities and count the company's security holders as beneficial owners of its securities.[16] The look-through provision currently applies (i) if a company owns 10% or more of a section 3(c)(1) fund's voting securities (''first 10% test'') and (ii) more than 10% of the company's total assets are invested in section 3(c)(1) funds generally (''second 10% test'').[17]

The 1996 Act's amendments to section 3(c)(1) are designed, in part, to

Company Regulation at 104 (1992) (hereinafter Protecting Investors Report).

[3] 138 Cong. Rec. at S4822 (daily ed. Apr. 2, 1992) (Memorandum of the Securities and Exchange Commission in Support of the Small Business Incentive Act of 1992) (hereinafter Commission Memorandum). Some commenters also suggested that section 3(c)(1)'s 100-investor limit may have had the effect of providing an incentive for Americans to invest in unregulated off-shore markets. *See* S. Rep. No. 293, 104th Cong., 2d Sess. at 10 (1996) (hereinafter Senate Report); H.R. Rep. No. 622, 104th Cong., 2d Sess. at 18 (1996) (hereinafter House Report). These Reports relate to bills that were eventually enacted as the National Securities Markets Improvement Act of 1996, Pub. L. No. 104–290 (1996) (the ''1996 Act'') (to be codified in scattered sections of the United States Code (''U.S.C.''); U.S.C. references are to the sections in which the relevant provisions of the 1996 Act will be codified).

[4] 1996 Act section 209; 15 U.S.C. 80a–3(c)(7). As is the case for a section 3(c)(1) fund, a section 3(c)(7) fund cannot make, or propose to make, a public offering of its securities.

[5] 15 U.S.C. 80a–2(a)(51)(A)(i).

[6] A Family Company is a company ''that is owned directly or indirectly by or for two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established for the benefit of such persons . . . .'' 15 U.S.C. 80a–2(a)(51)(A)(ii).

[7] A trust may be a qualified purchaser if (i) it was not formed for the specific purpose of acquiring the securities offered, and (ii) the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, are qualified purchasers. 15 U.S.C. 80a–2(a)(51)(A)(iii).

[8] A qualified purchaser that meets the $25 million threshold may act for its own account or for the accounts of other qualified purchasers. 15 U.S.C. 80a–2(a)(51)(A)(iv).

[9] 1996 Act section 209(d)(2). Such rules are required to be prescribed by April 9, 1997 (180 days after the enactment of the 1996 Act). The provisions of the 1996 Act enacting section 3(c)(7) take effect on the earlier of April 9, 1997 or the date on which the rulemaking defining the term investments is completed.

[10] 15 U.S.C. 80a–3(c)(7)(B).

[11] *See* 142 Cong. Rec. at E1938 (Oct. 21, 1996) (Remarks of Hon. John D. Dingell); The Investment Company Act Amendments of 1995: Hearing on H.R. 1495 Before the Subcomm. on Telecommunications and Finance of the Comm. on Commerce, House of Representatives, 104th Cong. 1st Sess. (1995) (prepared statement of Marianne Smythe); *see also* American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities, Task Force on Hedge Funds, Report on Section 3(c)(1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchasers, 51 Bus. Law. 773, 779 (Dec. 5, 1995) (hereinafter Hedge Funds Task Force Report). The grandfather provision is not intended, however, to allow a sponsor of a section 3(c)(1) fund to nominally give the fund section 3(c)(7) status in order to be able to operate another section 3(c)(1) fund and thereby circumvent the 100-investor limit. Remarks of Hon. John D. Dingell, *supra; see also* section II.D of this Release.

[12] 15 USC 80a–3(c)(7)(B)(ii).

[13] *See* 142 Cong. Rec. at E1929 (Oct. 4, 1996) (Remarks of Hon. Thomas J. Bliley, Jr.).

[14] 1996 Act section 209(d)(4). Such rules are required to be prescribed by April 9, 1997. *See supra* note 9.

[15] 15 USC 80a–2(a)(51)(C).

[16] Section 2(a)(42) of the Investment Company Act [15 USC 80a-2(a)(42)] defines a voting security as any security ''presently entitling the holder thereof to vote for election of directors [of the issuer] thereof.'' *See* Thomas P. Lemke and Gerald T. Lins, *Private Investment Companies Under Section 3(c)(1)*, 44 Bus. Law. 401, 416–18 (Feb. 1989) (discussing the types of non-voting interests that have been treated as voting securities).

[17] To illustrate the operation of the current look-through provision, assume Company A is seeking to rely on the provisions of section (3)(c)(1). If one of Company A's security holders, Company B, beneficially owns 10% or more of Company A's voting securities, then the security holders of Company B would be counted as security holders of Company A (under the first 10% test), unless no more than 10% of Company B's assets consist of securities of section 3(c)(1) funds (the second 10% test).

The operation of the look-through provision also is relevant to determining who is a beneficial owner of a section 3(c)(1) fund's securities for purposes of the grandfather and the consent provisions. *See* section II.B. of this Release.

simplify the way in which the number of investors in a fund is calculated for purposes of the 100-investor limit.[18] When the relevant provisions of the 1996 Act become effective,[19] the amended look-through provision will no longer apply to a security holder that is an operating company (*i.e.*, a company that is not an investment company or a private fund).[20] This approach recognizes that an investment in a section 3(c)(1) fund by a company that is not itself an investment company generally does not implicate the concerns that the look-through provision was intended to address—that the investor may be a conduit that was created to enable a section 3(c)(1) fund to have indirectly more than 100 investors.[21]

The 1996 Act not only limits the scope of the look-through provision, but also seeks to simplify it by eliminating the second 10% test. The look-through provision will apply whenever an investment company, including a private fund, owns 10% or more of a section 3(c)(1) fund, regardless of whether or not the investment company has more than 10% of its assets invested in section 3(c)(1) funds generally. This change reflects the view that the private nature of a section 3(c)(1) fund may be brought into question when an investment company has a substantial investment in the section 3(c)(1) fund.[22]

These amendments, while attempting to simplify the look-through provision and make it more consistent with its regulatory purpose, may create interpretative issues for existing section 3(c)(1) funds that have investors to which the first, but not the second, 10% test applies. The Commission is proposing a rule to address these issues.

C. Other Directed Rulemaking

The 1996 Act directs the Commission to prescribe two sets of rules relating to private funds.[23] The 1996 Act directs the Commission to prescribe rules permitting ''knowledgeable employees'' of a private fund (or knowledgeable employees of the fund's affiliates) to invest in the fund without causing the fund to lose its exclusion from regulation under the Investment Company Act.[24] The purpose of this provision appears to be to allow private funds to offer persons who participate in the funds' management the opportunity to invest in the fund as a benefit of employment.[25]

The Commission is proposing a rule to allow directors, executive officers, general partners, and other knowledgeable employees of a section 3(c)(1) fund to invest in the fund without being counted for purposes of the fund's 100-investor limit. The proposed rule similarly would allow knowledgeable employees of a section 3(c)(7) fund to invest in the fund even though they may not meet the definition of qualified purchaser. The rule also would permit investments by knowledgeable employees of affiliates that manage the investment activities of these funds.

In addition to directing the Commission to adopt rules relating to investments by knowledgeable employees, the 1996 Act directs the Commission to prescribe rules implementing section 3(c)(1)(B) of the Act.[26] Section 3(c)(1)(B) provides that beneficial ownership of securities of a section 3(c)(1) fund by any person who acquires the securities as a result of ''a legal separation, divorce, death, or other involuntary event'' will be deemed to be beneficial ownership by the person from whom the transfer was made, pursuant to such rules and regulations as the Commission prescribes.[27] The Commission is proposing a rule to permit securities acquired by a person as a result of certain transfers to be treated as being beneficially owned by the original beneficial owner. The proposed rule would address similar transfers of securities issued by section 3(c)(7) funds.[28]

II. Rules Relating to Qualified Purchaser Funds

A. Investments

The 1996 Act provides that the term investments is to be defined by Commission rule. Section 2(a)(51)(B) of the Act also gives the Commission authority to prescribe such rules and regulations governing qualified purchasers as the Commission determines are necessary or appropriate in the public interest or for the protection of investors.

In explaining why Congress deferred to the Commission's defining what constitutes an investment for purposes of the $5 million/$25 million thresholds, the legislative history of the 1996 Act indicates that section 3(c)(7) funds are to be limited to investors with a high degree of financial sophistication who are in a position to appreciate the risks associated with investment pools that do not have the protections afforded by the Investment Company Act.[29] These investors are likely to be able to evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage and redemption or withdrawal rights.[30] Congress appears to have expected that the definition of investments be broader than securities, but not that every asset be treated as an investment. Rather, the legislative history suggests that the asset should be held for investment purposes and that the nature of the asset should indicate a significant degree of investment experience and sophistication such that the investor can be expected to have the knowledge to evaluate the risks of investing in unregulated investment pools.[31]

Proposed rule 2a51–1 under the Investment Company Act seeks to define the term investments consistent with the principles set forth in the legislative history. The proposed rule would define investments broadly to include securities (other than controlling interests in all but certain issuers), and real estate, futures contracts, physical commodities, and cash and cash equivalents held for investment purposes. Proposed rule 2a51–1 also contains certain provisions designed to clarify how the amount of a person's investments would be determined (including investments held jointly with a spouse and investments held by certain affiliated entities). The proposed rule would permit a section 3(c)(7) fund to rely, in good faith, on certain documentation in determining a person's eligibility as a qualified purchaser.

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[18] These changes also had been recommended by the Commission in 1992. *See* Commission Memorandum, *supra* note 3; *see also* Protecting Investors Report, *supra* note 2, at 108–09.

[19] The amendments to section 3(c)(1)(A) will become effective on the earlier of April 9, 1997 or the date on which the rulemaking defining the term investments is completed. 1996 Act section 209(e).

[20] 15 USC 80a–3(c)(1)(A).

[21] *See* Testimony of Arthur Levitt, Chairman, SEC, Concerning S. 1815, the Securities Investment Promotion Act of 1996, Before the Senate Committee on Banking, Housing and Urban Affairs (June 5, 1996).

[22] *See, e.g.*, Protecting Investors Report, *supra* note 2, at 106–09.

[23] 1996 Act section 209(d).

[24] 1996 Act section 209(d)(3). These rules are required to be promulgated no later than October 11, 1997 (1 year after enactment of the 1996 Act).

[25] *See The Investment Company Act Amendments of 1995: Hearing on H.R. 1495 before the Subcomm. on Telecommunications and Finance of the Comm. on Commerce, House of Representatives*, 104th Cong., 1st Sess. 22–23 (1995) (testimony of Barry P. Barbash, Director, Division of Management, SEC).

[26] 1996 Act section 209(d)(1).

[27] 15 USC 80a–3(c)(1)(B).

[28] *See* 15 USC 80a–3(c)(7)(A) (permitting certain transfers by qualified purchasers).

[29] *See* Senate Report, *supra* note , at 10.

[30] *Id.*

[31] The Senate Report gave family-owned businesses and personal residences as examples of assets that should not be considered to be investments. *See id.* at 10.

1. Definition of Investments

a. Securities

Proposed rule 2a51–1(b)(1) would include securities within the definition of investments. Defining investments in this way should result in a broad range of investments being treated as such for purposes of section 3(c)(7). Many investment opportunities are offered through entities that issue securities, such as limited partnerships and limited liability companies.[32]

Under the proposed rule, securities of an issuer with which the prospective qualified purchaser has a control relationship generally would not come within the definition of investments for purposes of section 3(c)(7).[33] Limiting the definition in this manner is designed to exclude, among other things, controlling ownership interests in family-owned and other closely held businesses, and controlled subsidiaries of operating companies. These holdings would appear not to demonstrate the degree of financial sophistication necessary to invest in unregulated investment vehicles or securities generally.

The proposed rule would not exclude from the definition of investments controlling ownership interests in investment companies and other issuers excepted from the definition of investment company by sections 3(c)(1) through 3(c)(9) of the Act.[34] Ownership of a controlling interest in these types of companies generally suggests a significant degree of investment experience. The proposed rule also would not exclude a controlling ownership interest in a ''listed'' company (*e.g.*, a company whose equity securities are listed on a national securities exchange, traded on the National Association of Securities Dealers Automated Quotation System (''NASDAQ'') or listed on an offshore securities exchange) that is not a majority-owned subsidiary of the prospective qualified purchaser.[35] A controlling ownership interest in a company listed on a national securities exchange or traded on NASDAQ is likely to evidence knowledge of and experience in dealing with investment risk, securities-related disclosure, corporate governance, transactions with affiliates, leverage, and other issues relevant to a person's ability to evaluate investment in a pooled investment vehicle. The proposed inclusion of securities traded on a ''designated offshore securities market'' is intended to include securities of foreign issuers that trade in an organized market that is not regulated by the Commission.

Comment is requested on the proposed exclusions from the definition of investments for certain securities. Should other controlling interests (such as controlling interests in large, but privately held, companies) be treated as investments for purposes of section 3(c)(7)?[36] In the alternative, should the listed company exception be applicable if any securities of the issuer have been offered to the public, even if periodic reports with respect to the issuer's securities are no longer required to be filed under the Securities Exchange Act of 1934 (''Exchange Act'')?[37] Should foreign securities be considered listed securities based on criteria other than, or in addition to, whether they trade on a designated offshore securities market (such as a public float requirement or a requirement that American Depositary Receipts with respect to these securities be traded in the U.S.)?

Comment also is requested whether other types of business holdings (whether or not characterized as securities) should be treated as investments. For example, should any passive ownership interest in a trade or business be considered to be an investment?[38] Finally, comment is requested whether other types of securities should be excluded from the definition of investments because they do not serve as an appropriate measure of investment experience.

b. Real Estate

Proposed rule 2a51–1(b)(2) would include real estate held for investment purposes within the definition of investments. Consistent with the examples provided by the legislative history of the 1996 Act, real estate would not be considered to be held for investment purposes if the real estate is used by the prospective qualified purchaser or a member of the prospective qualified purchaser's family (''related person'') for personal purposes (*e.g.*, as a personal residence).[39] The term ''personal purposes'' is derived from the Internal Revenue Code provision that addresses circumstances under which a taxpayer is allowed deductions with respect to certain ''dwelling units.''[40] Thus, residential property could be treated as an investment if it is not treated as a residence for tax purposes. The Commission believes that reference to the Internal Revenue Code provisions is appropriate because it would allow prospective qualified purchasers to determine whether the residential real estate is an investment based on the same provisions they would apply in

[32] For example, the term security includes any ''fractional undivided interest in oil, gas or other mineral rights.'' *See* section 2(1) of the Securities Act of 1933 (''Securities Act'') [15 USC 70a(1)].

[33] The proposed rule would exclude from the definition of investments securities of an issuer that ''controls, is controlled by, or is under common control with, the person that owns the securities.'' The term ''control'' is defined in section 2(a)(9) of the Act as ''the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.'' 15 USC 80a-2(a)(9). Section 2(a)(9) also provides that a person who owns beneficially, ''either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company.'' *Id.*

[34] 15 USC 80a–3(c) (1) through (9). In addition to private investment companies, sections 3(c)(1) through (9) except from the definition of investment company certain types of issuers that engage in significant investment-related activities (*i.e.*, brokers and other financial intermediaries, banks, insurance companies, and finance companies). A controlling interest in a foreign bank, foreign insurance company or structured finance vehicle also would be included as an investment, even if the issuer is not considered to be an investment company under rules 3a–6 or 3a–7 under the Act [17 CFR 270.3a–6 and 3a–7].

[35] A company would be considered to be a ''listed company'' if it has outstanding a class of equity securities that are (i) ''reporting securities'' under rule 11Aa3–1 of the Securities Exchange Act of 1934 (''Exchange Act'') [17 CFR 240.11Aa3–1] (*i.e.*, securities listed and registered, or admitted to unlisted trading privileges, on a national securities exchange or for which quotation information is disseminated in the NASDAQ and for which transaction reports are required to be made on a real-time basis pursuant to an effective transaction reporting plan) or (ii) listed on a ''designated offshore securities market'' (as such term is defined in Regulation S under the Securities Act [17 CFR 230.901 *et seq.*]).

[36] For example, a controlling interest in a company that has shareholders equity in excess of a specified amount (*e.g.*, $50 million or $100 million) could be treated as an investment on the theory that the size of the company suggests a certain level of financial sophistication on the part of the control person.

[37] *See* sections 12(b), 12(g) and 15(d) of the Exchange Act [15 USC 78*l*(b), 78*l*(g) and 78*o*(d)].

[38] A passive ownership interest could be defined for these purposes as an interest in a trade or business in which such person does not materially participate. *See* Internal Revenue Code (''IRC'') section 469(c)(1) [26 USC 469(c)(1)].

[39] Proposed rule 2a51–1(c). Proposed rule 2a51–1(a)(5) would define ''related person'' as a sibling, spouse or former spouse of the prospective qualified purchaser, or a direct lineal descendant or ancestor by birth or adoption of the prospective qualified purchaser, or a spouse of such descendant. *See also* section 2(a)(51)(A)(ii) of the Act [15 USC 80a–2(a)(51)(A)(ii)] (specifying who is considered a family member for purposes of the Family Company definition).

[40] IRC section 280A(d) [26 USC 280A(d)]. The proposed rule would treat residential real estate as an investment if it is not treated as a dwelling unit used as a residence in determining whether deductions for depreciation and other items are allowable under the IRC. Section 280A provides, among other things, that a taxpayer uses a dwelling unit during the taxable year as a residence if he or she uses such unit for personal purposes for a number of days that exceeds the greater of 14 days or 10 percent of the number days during which the unit is rented at a fair market value.

determining whether certain expenses related to the property are deductible for purposes of completing their tax returns. Comment is requested on the proposed approach. Would alternative approaches (such as not treating the property as held for investment purposes if it is used *at any time* for personal purposes) be easier to apply?

Property owned by the prospective qualified purchaser that has been used by the prospective qualified purchaser or a related person as a place of business or in connection with the conduct of a trade or business (''business-related property'') would not be considered to be held for investment purposes.[41] While business-related property may have been acquired with an investment goal in mind, these holdings may not be indicative of extensive experience in the financial or real estate markets and may have been acquired for reasons other than the potential investment merits of the property.

Comment is requested on including real estate as an investment for purposes of the proposed rule. Does real estate investing sufficiently reflect the kind of financial sophistication required to understand the risks of investing in an unregulated investment pool? Should real estate be included as an investment for purposes of the proposed rule only if the investment is in the form of a security?

c. Commodity Interests

Proposed rule 2a51–1(b)(3) would include contracts for the purchase or sale of a commodity for future delivery (''commodity interests'') held for investment purposes within the definition of investments.[42] Commodity interests are often used by investors to hedge their portfolios from declines in securities prices, changes in interest rates, or foreign currency fluctuations. Commodity interests also may provide a means to invest in the commodities markets.

Commodity interests would be included as investments to the extent of the initial margin and option premium deposited with a futures commission merchant.[43] This approach is similar to that taken by rule 4.7 under the Commodity Exchange Act, which makes available a simplified regulatory framework for private commodity pools offered to certain sophisticated investors.[44] Gains and losses on commodity interests generally would be reflected in changes in the prospective qualified purchaser's cash position (which also could be treated as an investment).[45] Comment is requested on the proposed approach to treating commodity interests. Since the value of the commodity interest generally would be reflected in the investor's cash position (including initial margin), is it necessary for the rule to include commodity interests? Would the rule be easier to apply if it explicitly provided that ''variation margin'' posted to the commodity account of the prospective qualified purchaser to reflect gains could be treated as an investment for purposes of the rule? Would another formulation for determining how to value commodity interests be more appropriate?

The proposed rule also would include in the definition of investments commodities that are held in physical form and for investment purposes.[46] This provision would recognize that many investors hold gold, silver or other commodities as part of their investment portfolios. Commodities that are used as part of a trade or business (such as grain held by a food processor as part of its inventory or raw materials) would not be considered to be investments.

Comment is requested on the proposed inclusion of commodity interests and commodities within the definition of investments. Should any other types of financial instruments, to the extent they are not addressed by the proposed rule, be included within the definition of investments?[47]

d. Cash and Cash Equivalents

Proposed rule 2a51–1(b)(5) would include cash and cash equivalents held for investment purposes (''cash'') in the definition of investments.[48] The Commission is proposing to include cash as an investment to reflect its views that many investors are likely at any given time to have a component of their investment portfolio in cash.[49] The rule would specify that the cash would have to be held by the prospective qualified purchaser for investment purposes. Thus, cash used by the prospective qualified purchaser to meet its day-to-day expenses (or, in the case of a prospective qualified purchaser that is a business, its working capital) would

[41] Proposed rule 2a51–1(c).

[42] Paragraph (a)(1) of proposed rule 2a51–1 would define commodity interests to mean commodity futures contracts, options on a commodity futures contracts, and options on physical commodities traded on or subject to the rules of (a) any contract market designated for trading such transactions under the Commodity Exchange Act (the ''CEA'') [7 USC 1 *et seq.*] and the rules thereunder; or (b) any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules under the CEA. 17 CFR 30.1 through 30.11.

A futures contract generally is a bilateral agreement providing for the purchase or sale of a specified commodity at a stated time in the future for a fixed price. Robert E. Fink & Robert B. Feduniak, Futures Trading at 10 (1988). A commodity option gives its holder the right, for a specified period of time, to either buy (in the case of a call option) or sell (in the case of a put option) the subject of the option at a predetermined price. The writer (seller) of an option is obligated to sell or buy the specified commodity at the election of the option holder. 1 Philip M. Johnson & Thomas L. Hazen, Commodities Regulation at section 1.07 (2d ed. Supp. 1994) (hereinafter Johnson & Hazen).

[43] Proposed rule 2a51–1(d)(1). To enter into a futures contract or write a commodity option, a customer typically deposits with a futures commission merchant (''FCM''), as security for performance of its obligations, a specified amount of assets or cash as ''initial margin.'' Initial margin is not considered part of the contract or option price, and is returned upon termination of the position, unless used to cover a loss. Johnson & Hazen, *supra* note 42, at section 1.10.

[44] 17 CFR 4.7. In taking this approach, the Commodity Futures Trading Commission noted that ''account equity in excess of the minimum necessary for margin or option premiums is not includable because it has no necessary correlation with actual commodity interest transactions.'' *See* Exemption for Commodity Pool Operators With Respect to Offerings to Qualified Eligible Participants; Exemption for Commodity Trading Advisors With Respect to Qualified Eligible Clients, 57 FR 34853, 34855 n.17 (Aug. 7, 1992). Rule 4.7 under the CEA establishes a different threshold for securities investments ($2,000,000 market value) and commodity interests ($200,000 initial margin). Since the proposed rule would permit cash to be treated as an investment (*see* section II.A.2.d. of this Release), it would not be appropriate to incorporate this dual threshold into the proposed rule.

[45] See section II.A.1.d of this Release. An FCM must, on a daily basis, reconcile its customers' positions by crediting gains and debiting losses on a customer-by-customer basis. *See* CEA rule 1.32 [17 CFR 1.32] (requiring daily computation of customer accounts); *see also* Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, Investment Company Act Rel. No. 22389 (Dec. 11, 1996) [61 FR 66207 (Dec. 17, 1996)].

[46] Proposed rule 2a51–1(b)(4). Physical commodities, for purposes of the proposed rule, would be defined as any commodity with respect to which a commodity interest is traded on a domestic or foreign commodities exchange. Proposed rule 2a51–1(a)(4). This approach is designed to provide certainty on the types of commodities that would be considered investments.

[47] *See, e.g.,* section 3(c)(2) of the Act, as amended by the 1996 Act [15 USC 80a–3(c)(2)] (defining the term ''financial contract'').

[48] Cash and cash equivalents would generally be considered to include cash, bank deposits, certificates of deposit, bankers acceptances and other bank instruments. *See, e.g.,* Investment Company Act Rel. No. 10937 (Nov. 13, 1979) [44 FR 66608 (Nov. 20, 1979)]; Statement of Cash Flows, Statement of Financial Accounting Standards No. 95, at section 95.08 (Fin. Accounting Standards Bd. 1987); Treas. Reg. section 220.2 (as amended in 1996) [Fed. Sec. L. Rep. (CCH) ¶ 22,252]. The cash surrender value of an insurance policy (net of any loans) would also be considered to be a cash equivalent. Certain of the instruments that are considered to be cash equivalents (*e.g.,* shares of money market mutual funds, certain Government securities) for purposes of these sources are securities and would be treated as investments for purposes of the proposed rule.

[49] For example, an investor may have a significant amount of cash as a result of a recent sale of an investment or because market conditions resulted in the investor taking a ''defensive'' position. Cash or cash equivalents may also be integral to certain sophisticated investment strategies (such as hedging).

not be included for purposes of determining whether the prospective qualified purchaser has the requisite amount of investments.

Comment is requested on the proposed inclusion of cash as an investment. Should cash only be included if it is in excess of a certain amount (*e.g.*, $25,000)? Should the rule provide examples of when cash would be considered to be held for investment purposes (*i.e.*, if it represents proceeds from the sale of investments occurring during the preceding six months)? Should cash be included only if ''investment securities'' and other types of investments (*e.g.*, real estate) constitute more than a specified average amount or percentage of the prospective qualified purchaser's investment portfolio (*e.g.*, 25%, 50% or 75%) over the prior 12-month period?[50]

e. Request For Comment

Comment is generally requested on the proposed definition of investments. Certain assets (such as jewelry, art work, antiques, and other collectibles) that may be held by some individuals as investments are not included because they do not necessarily suggest any experience in the financial markets or investing in unregulated investment pools.[51] Should such assets be included if held for investment purposes? Should any property that produces income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business be treated as an investment?[52] Commenters should explain how these types of investments can serve as indicia of sophistication in investment matters. Finally, should any assets that are proposed to be included within the definition of investments not be included?

2. Determining the Amount of Investments

Proposed rule 2a51–1 would allow the amount of a prospective qualified purchaser's investments to be based on either the market value of the investments or their cost. In either case, certain deductions from the amount of investments owned would have to be made as discussed below.

a. Value of Investments

Proposed rule 2a51–1(d) would specify that the value of an investment would be determined based either on its market value on a recent date or its cost.[53] A section 3(c)(7) fund could determine which methodology to use, or could allow prospective qualified purchasers to provide the amount of their investments based on either methodology. The Commission believes that this approach is appropriate because either the cost or market value of the prospective qualified purchaser's investments may provide an appropriate starting point for assessing the person's investment experience.

Comment is requested on the proposed approach to valuing investments. Should the proposed rule instead take an approach similar to that taken in rule 144A under the Securities Act, which generally requires that securities be valued at cost even if a market value is available?[54] Would that approach make it easier for a section 3(c)(7) fund to determine the continuing status of an investor as a qualified purchaser when the investor adds to its investment in the fund?[55]

b. Deductions From Amount of Investments

(i) Certain Indebtedness

The Commission believes that, in establishing the $5 million/$25 million investment thresholds, Congress intended that qualified purchasers generally be limited to persons who own a specified amount of investments. This intention would appear to be inconsistent with permitting a prospective qualified purchaser to accumulate the requisite amount of investments through leverage or similar means. As a result, the proposed rule would require that the amount of any outstanding indebtedness incurred to acquire investments owned by a prospective qualified purchaser be deducted from that person's amount of investments. This requirement would apply to all types of prospective qualified purchasers.[56]

The Commission is concerned that section 3(c)(7) funds may have difficulty in determining whether certain indebtedness was incurred to acquire investments. To address this issue, the proposed rule would require that certain indebtedness, if incurred during the preceding 12 months, be deducted from the amount of the person's investments, regardless of whether the proceeds of the indebtedness can be directly traced to the acquisition of investments. These provisions are generally applicable to natural persons and Family Companies.

The amount of any loan to a natural person secured by a mortgage on the person's personal residence or other non-investment real estate would be deducted unless the proceeds of the loan were used solely to finance the acquisition or improvement of the property or to refinance an outstanding mortgage (''real estate loans'').[57] The intent of this provision is to preclude a personal residence or a vacation home from, in effect, being converted into cash or another type of investment for purposes of meeting the $5 million threshold.[58]

Under the proposed rule, a Family Company would be required to deduct the amount of any outstanding indebtedness incurred by any of the Company's owners to acquire the investments held by the Company.[59] In addition, a Family Company would have to deduct the amount of any real estate loans that any owner of the Family Company would have had to deduct if the owner were the

[50] Section 3(a)(3) of the Act [15 USC 80a–3(a)(3)] defines the term ''investment securities'' as all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies. Upon effectiveness of the 1996 Act's amendments related to section 3(c)(7) funds, the term investment securities also will exclude majority-owned subsidiaries that are section 3(c)(1) or section 3(c)(7) funds. *See* section 209(c)(6) of the 1996 Act.

[51] *See* Hedge Funds Task Force Report, *supra* note 11, at 788 (suggesting that automobiles, jewelry and art be excluded from investments for purposes of measuring financial sophistication).

[52] *See* IRC section 163(d)(5) [26 USC 163(d)(5)] (definition of ''property held for investment'' under tax code provisions allowing a limited deduction for investment interest).

[53] In the case of a security, market value could be determined in the manner described in rule 17a–7(b) under the Investment Company Act [17 CFR 270.17a–7(b)]. In the case of other investments, other reasonable methods to ascertain market value (such as real estate appraisals by independent third parties) could be used. A prospective qualified purchaser could not use a ''fair value'' method of valuation such as that contemplated by rule 2a–4 under the Act [17 CFR 270.2a–4]. In the absence of a readily ascertainable market value, the value of an investment always would be based on its cost.

[54] *See* 17 CFR 230.144A(a)(3) (requiring securities to be valued at cost, unless a person reports its securities holdings in its financial statements on the basis of their fair market value, or no current information with respect to the cost of those securities has been published).

[55] *See* section 3(c)(7)(A) of the Investment Company Act (providing that the outstanding securities of a section 3(c)(7) fund must be owned ''exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers'').

[56] Proposed rule 2a51–1(e). The proposed rule would not require the deduction to be made with respect to investments that the person manages on a discretionary basis for others.

[57] Proposed rule 2a51–1(f) (4) and (5). The proceeds of a refinancing loan would be deducted to the extent that the amount of the new loan exceeds the lowest principal amount of the refinanced loan outstanding during the preceding 12 months.

[58] This deduction would generally apply to real estate that is not held for investment purposes. Outstanding indebtedness incurred to acquire investment real estate would already have been deducted as required by proposed rule 2a51–1(e).

[59] Proposed rule 2a51–1(g)(1).

prospective qualified purchaser.[60] Finally, the proposed rule would require a Family Company to deduct (i) the amount of any indebtedness incurred by the Family Company during the preceding 12 months to the extent that the principal amount of the indebtedness exceeds the fair market value of any assets of the Family Company other than investments and (ii) the amount of any indebtedness incurred during the preceding 12 months by an owner of the Family Company or by a related person of an owner of the Family Company and guaranteed by the Family Company.[61] These provisions would provide further assurance that indebtedness incurred by the Family Company or its owners to acquire investments was appropriately deducted.

Comment is requested whether the rule should contain other provisions to clarify the extent to which indebtedness should be treated as incurred to acquire the investment. For example, should any indebtedness collateralized by the investment (whether directly or indirectly) be deemed to have been incurred to acquire the investment?

(ii) Other Payments

Prospective qualified purchasers who are natural persons would be required to deduct from the amount of their investments certain other amounts received during the preceding 12 months that could inflate the amount of their investments (particularly cash) without reflecting any investment experience. These amounts include payments received pursuant to an insurance policy; the value of any investments received by the person as a gift or bequest or pursuant to an agreement related to a legal separation or divorce; and any amount received by the person in connection with a lawsuit.[62]

(iii) Request for Comment

Comment is requested concerning the proposed approach for deducting indebtedness and other payments. Should the rule establish guidelines or presumptions concerning whether indebtedness was incurred to acquire an investment? Should other specified types of indebtedness or payments be deducted from the amount of investments?

Comment also is requested whether the 12-month period is sufficient to establish, for example, that a person who has received a $5 million bequest is sufficiently sophisticated to be treated as a qualified purchaser based on investments that may have been made with that bequest? Would a longer (*e.g.*, 24 months) or shorter (*e.g.*, six months) period be more appropriate? In lieu of, or in addition to, the 12-month period, should the rule reduce the amount of the deductions to the extent that the prospective qualified purchaser can trace the use of the proceeds of the loans or other payments to non-investment activities?

3. Jointly Held Investments

The proposed rule would clarify that, in determining whether a natural person is a qualified purchaser, there may be included in the value of such person's investments any investments held jointly with such person's spouse (''joint investments'').[63] Thus, a person who owns $3 million of investments individually and $2 million of joint investments would be a qualified purchaser. The spouse also would be a qualified purchaser if he or she owned, individually, an additional $3 million of investments. On the other hand, if each spouse owned, individually, $3 million of investments, but the spouses did not own any joint investments, neither spouse would be a qualified purchaser.[64] Comment is requested on the proposed approach to joint investments. Should spouses that hold not less than $5 million in investments in the aggregate (regardless of whether the investments are held jointly) be treated as qualified purchasers if they make a joint investment in a section 3(c)(7) fund?

4. Investments Held by Certain Corporate Affiliates

The proposed rule generally would permit a parent company in a corporate structure that is a prospective qualified purchaser to aggregate investments it owns with those owned by its wholly-owned and majority-owned subsidiaries. The investments of these affiliated entities would have to be managed under the direction of the parent company.[65] This approach appears to be an appropriate way to address, for example, holding company structures necessitated by legal, tax or other factors that may require or make advantageous the holding of investments in separate corporate entities.[66] Comment is requested whether there are other structures for holding ownership interests in investments that should be addressed by the proposed rule. Should the rule also require the subsidiary to be consolidated with the parent company under Generally Accepted Accounting Principles?[67]

5. Good Faith Reliance on Certain Documentation

The proposed rule would permit a section 3(c)(7) fund or a person acting on its behalf, when determining whether a prospective investor is a qualified purchaser, to rely upon audited financial statements, brokerage account statements and other appropriate information and certifications provided by the prospective purchaser or its representatives, as well as upon publicly available information as of a recent date.[68] Reliance on this information must be reasonable and the section 3(c)(7) fund or its representatives, after reasonable inquiry, must have no basis for believing that the information is incorrect in any material respect. Comment is requested whether rule 2a51–1 should include a list of documentation similar to that included in rule 144A under the Securities Act.[69]

B. Definitions of Beneficial Ownership

Proposed rule 2a51–2 would define the term ''beneficial owner'' for

[60] Proposed rule 2a51–1(g)(2).

[61] Proposed rule 2a51–1(g)(3) and (4).

[62] Proposed rule 2a51–1(f)(1) through (3). A Family Company would have to deduct any such payments received by the Company or by any owner of the Company. Proposed rule 2a51–1(g)(2).

[63] Proposed rule 2a51–1(h). Joint investments also would include investments in which the person shares with his or her spouse a community property or similar shared ownership interest. *Id*. In determining the amount of joint investments, the prospective qualified purchaser would have to deduct from the amount of any joint investments any amounts that the spouse would have had to deduct (*e.g.*, indebtedness incurred to acquire the investments or bequests received by the spouse). *Id*.

[64] This rule would not affect whether a spouse that is not a qualified purchaser can hold a joint interest in a section 3(c)(7) fund with his or her qualified purchaser spouse. Section 2(a)(51)(A)(i) of the Act provides that such a joint interest can be held.

[65] Proposed rule 2a51–1(i).

[66] *See, e.g.*, Resale of Restricted Securities; Changes To Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Rel. No. 6862 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)] (describing bank holding company structures).

[67] *See* rule 144A(a)(4) under the Securities Act [17 CFR 230.144A(a)(4)].

[68] Proposed rule 2a51–1(j). The legislative history of the 1996 Act indicates that the Commission can use its rulemaking authority provided in section 2(a)(51) of the Act to ''develop reasonable care defenses when an issuer relying on the qualified purchaser exception in good faith sells securities to a purchaser that does not meet the qualified purchaser definition.'' House Report, *supra* note 3, at 53.

[69] 17 CFR 230.144A(d)(1). Rule 144A includes several non-exclusive methods for purposes of determining whether a person is a ''qualified institutional buyer.'' These methods include most recent publicly available financial statements, information filed with Federal and State regulatory authorities, and information appearing in recognized securities manuals, as well as certifications by a company's executive officers. *Id*.

purposes of the grandfather provision governing section 3(c)(1) funds that wish to convert into section 3(c)(7) funds and the consent provision governing section 3(c)(1) funds that wish to become qualified purchasers. The proposed rule also would address what types of ownership constitute ''indirect'' beneficial ownership for purposes of the consent provision.

1. The Grandfather Provision

Under the grandfather provision, a Grandfathered Fund may convert into a section 3(c)(7) fund without requiring investors that are not qualified purchasers to dispose of their interests in the fund.[70] The grandfather provision requires the Grandfathered Fund, prior to the conversion, (i) to disclose to each ''beneficial owner'' that future investors will be limited to qualified purchasers, and that ownership in the Grandfathered Fund will no longer be limited to 100 persons, and (ii) concurrently with or after the disclosure, to provide each beneficial owner with a reasonable opportunity to redeem any part or all of its interests in the fund for that beneficial owner's proportionate share of the fund's net assets.[71]

The 1996 Act directs the Commission to define the term ''beneficial owner'' for purposes of the grandfather provision. The legislative history of the 1996 Act suggests that the Commission was to use this authority to address any unnecessary burdens that might arise as a result of the application of section 3(c)(1)'s look-through provision.[72] Specifically, Congress appears not to have intended to require a Grandfathered Fund to provide the notice and redemption opportunity to security holders of its institutional investors, even when those security holders would be deemed beneficial owners of the Grandfathered Fund's voting securities under section 3(c)(1)(A).[73] Rather, the notice and redemption opportunity are generally intended to be provided only to the institutional investor, unless the institutional investor is controlled by or under common control with the Grandfathered Fund.[74]

Consistent with the purposes indicated in the legislative history of the 1996 Act, the Commission believes that the grandfather notice and redemption opportunity provisions were intended not only for the purposes described above, but for the benefit of certain persons who were deemed to be beneficial owners *prior* to the 1996 Act's amendments to the look-through provision.[75] These persons may have relied on the then-existing look-through provision as a way to limit the Grandfathered Fund's ability to sell its securities to additional investors.[76] Allowing the Grandfathered Fund to raise substantial new capital from an unlimited number of qualified purchasers could significantly alter the nature of an investment in the Grandfathered Fund.

Paragraph (a) of proposed rule 2a51–2 would provide generally that beneficial ownership is to be determined in accordance with section 3(c)(1) of the Act. Paragraph (b) of the proposed rule would provide a special rule for determining beneficial ownership of securities held by a company. Paragraph (b) would provide that securities of a Grandfathered Fund beneficially owned by a company (without giving effect to the look-through provision) are deemed to be beneficially owned by one person (the ''owning company'') unless (i) on October 11, 1996, under section 3(c)(1)(A) of the Act as then in effect, the voting securities of the Grandfathered Fund were deemed to be beneficially owned by the holders of the owning company's outstanding securities,[77] (ii) the owning company has a control relationship with the Grandfathered Fund,[78] and (iii) the owning company is itself an investment company or a private fund.[79] If these conditions do not apply, the grandfather notice and redemption opportunity would be provided to the owning company. If the conditions do apply, the grandfather notice and redemption opportunity would be provided to the owning company's security holders as the beneficial owners of the Grandfathered Fund's securities.

The intended application of the proposed rule can best be illustrated by the following example. Assume Company A is a Grandfathered Fund and that Company B, a section 3(c)(1) fund, owned more than 10% of the voting securities of Company A on October 11, 1996. If Company B does not have a control relationship with Company A, the grandfather notice and redemption opportunity can be provided directly to Company B. If a control relationship does exist, and on October 11, 1996, the security holders of Company B were deemed to be the beneficial owners of Company A's voting securities (because of the second

[70] These non-qualified purchasers must have acquired all or a portion of their investment in the Grandfathered Fund prior to September 1, 1996. Any person acquiring an interest in the Grandfathered Fund after that date must, either on the date of the acquisition or on the date that the fund avails itself of the section 3(c)(7) exception, be a qualified purchaser. These persons are required to be given the notice and redemption opportunity described below.

[71] The opportunity must be provided ''notwithstanding any agreement to the contrary between the [Grandfathered Fund] and such beneficial owner.'' 15 USC 80a–3(c)(7)(B)(ii)(II). Each person electing to redeem must receive its proportionate share of the Grandfathered Fund's net assets in cash, unless the person agrees to accept such amount in kind (*i.e.*, in assets of the Grandfathered Fund). If the Grandfathered Fund elects to provide investors with an opportunity to receive an in-kind distribution, this election must be disclosed in the grandfather disclosure.

[72] *See supra* note 17 and accompanying text (describing section 3(c)(1)(A) of the Investment Company Act).

[73] *See* Remarks of Hon. Thomas J. Bliley, *supra* note 13.

[74] *Id.*

[75] *See supra* notes 18, 22 and accompanying text (discussing the elimination of the second 10% test). Consistent with this legislative intent, the Commission believes that the conditions in the grandfather provision must be complied with by any section 3(c)(1) fund organized before the enactment of the 1996 Act that wishes to avail itself of section 3(c)(7). Thus, the notice and redemption opportunity must be provided to the beneficial owners of a Grandfathered Fund's securities, even if each beneficial owner meets the definition of qualified purchaser. If the notice and redemption opportunity provision had been intended only for the benefit of beneficial owners who are not qualified purchasers, Congress could have limited the provision accordingly. *Compare* House Report, *supra* note 3, at 51 (describing original provision in H.R. 3005, as reported by the Committee on Commerce, which limited the notice and redemption opportunity to investors that were not qualified purchasers) and Senate Report, *supra* note 3, at 23 (''The issuer must allow section 3(c)(1) fund owners 'of record' to redeem their interests in the fund in either cash or a proportionate share of the fund's assets.''); *see also supra* note 70 .

[76] This reliance can be illustrated by the following example. An investor invested in a section 3(c)(1) fund (''Fund A'') through another section 3(c)(1) fund (''Fund B'') that was subject to the look-through provision as then in effect. The investor may have made its investment in Fund B (or Fund B may have made its investment in Fund A) recognizing that under section 3(c)(1)(A) as then in effect, each security holder of Fund B was deemed to be a beneficial owner of Fund A's voting securities. In this way, the look-through provision would have limited the number of additional persons that could invest in Fund A.

[77] The applicability of the look-though provision would be determined as of October 11, 1996 to assure that the Grandfathered Fund does not engage in transactions subsequent to the enactment of the 1996 Act (which was signed by the President on that date) designed to limit the applicability of the look-through provision (such as the issuance of additional voting securities so that the percentage of voting securities owned by an owning company falls below 10%).

[78] *See supra* note (describing the Act's definition of control).

[79] Limiting the application of the look-through provision in this context to owning companies that are investment companies or private funds is consistent with amended section 3(c)(1)(A). If the owning company is not an investment company or a private fund, its security holders are unlikely to have a sufficient interest in its investment in the Grandfathered Fund to justify providing them with the grandfather notice and redemption opportunity. *See supra* note 21 and accompanying text.

10% test),[80] Company A must provide the grandfather notice and redemption opportunity to each of Company B's security holders.

Comment is requested on the proposed approach for determining beneficial ownership in the absence of a control relationship. Should Company B's security holders receive the grandfather notice and redemption opportunity if Company B owns more than 10% of Company A's voting securities? That is, should Company B's security holders receive the grandfather notice and redemption opportunity regardless of (i) Company B's status as an investment company or a private fund; (ii) the existence of a control relationship, or (iii) the applicability of the second 10% test?

Comment also is requested whether any other rules may be necessary to clarify the operation of the grandfather provision. For example, a redeeming shareholder of a Grandfathered Fund is entitled to receive its proportionate share of the Fund's ''net assets.'' The term ''current net assets'' is used in the Investment Company Act and defined by Commission rule.[81] Should the same definition apply to Grandfathered Funds, or should net assets, for purposes of the grandfather provision, be determined based upon the methods that would have been used to determine the amount that the investor would have received in accordance with existing withdrawal provisions in the Grandfathered Fund's governing documents? Are these withdrawal provisions typically subject to conditions (*e.g.*, a ''hold-back'') that would undercut the purpose of the redemption requirements of section 3(c)(7) and, if so, how could the existence of such provisions be addressed?[82]

2. The Consent Provision

The consent provision requires that a private fund that wishes to become a qualified purchaser (''purchasing fund'') obtain the consent of all of its beneficial owners that had invested in the purchasing fund prior to April 30, 1996.[83] The beneficial owners of the securities of any private fund that is a direct or indirect beneficial owner of the securities of the purchasing fund must also consent to the treatment of the purchasing fund as a qualified purchaser.[84]

The consent provision appears to be designed to give investors in an existing private fund with the opportunity to review what could be a significant change in the manner in which the fund makes investments as a result of the regulatory changes effected by the 1996 Act.[85] The consent provision also may serve to prohibit an existing section 3(c)(1) fund from avoiding the notice and redemption opportunity requirements of the grandfather provision by investing its assets in a section 3(c)(7) fund, either directly or indirectly through another private fund.[86]

Paragraph (c) of proposed rule 2a51–2 would clarify the meaning of the term ''beneficial owner'' for purposes of the consent provision. The proposed rule would provide that securities of a purchasing fund beneficially owned by a company (without giving effect to the look-through provision) are deemed to be beneficially owned by one person unless the company has a control relationship with *either* the purchasing fund or the section 3(c)(7) fund with respect to which the purchasing fund will be a qualified purchaser (''target fund''). If a control relationship exists, and the company is a private fund whose security holders were deemed to be beneficial owners of the purchasing fund on October 11, 1996, then these security holders would be deemed to be beneficial owners under the proposed rule.

As in the case of the proposed definition of beneficial owner for purposes of the grandfather provision, the proposed rule relating to the consent provision is intended to allow an institutional investor to provide the required consent even if, under the look-through provision, the security holders of the institutional investor are deemed to be beneficial owners of the purchasing fund's securities. If there is a control relationship between the purchasing fund and either the institutional investor or the target fund, and the institutional investor is a private fund whose security holders were deemed beneficial owners of the purchasing fund prior to the enactment of the 1996 Act, then the consent must be obtained from those security holders.

The proposed rule also would clarify what constitutes ''indirect'' ownership with regard to the requirement that the consent be obtained from the security holders of a private fund that is an *indirect* beneficial owner of the purchasing fund. Paragraph (d) of the proposed rule would provide that the private fund would not be considered to own the securities of the purchasing fund indirectly unless the private fund has a control relationship with either the purchasing fund or the target fund.[87]

Under the proposed rule, the purchasing fund could obtain a general consent with respect to most transactions in which it will be a qualified purchaser. Consent for specific transactions would be required only when there is a control relationship between the purchasing fund or certain of its beneficial owners and the target fund.

Comment is requested on proposed rule 2a51–2. Comment specifically is requested on the proposed approach of

[80] *See* section I.B. of this Release.

[81] *See, e.g.,* section 2(a)(32) of the Investment Company Act [15 USC 80a–2(a)(32)] (defining the term redeemable security as a ''security * * * under the terms of which the holder * * * is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof'') and rule 2a–4 [17 CFR 270.2a–4] (definition of current net asset value for certain purposes).

[82] For example, if a section 3(c)(1) fund's withdrawal provision provides for a hold-back to assure that sufficient assets are available to satisfy contingent liabilities, the rule could provide that the Grandfathered Fund could not avail itself of section 3(c)(7) until the hold-backs are released or the liabilities extinguished.

[83] 15 USC 2(a)(51)(C). Section 2(a)(51)(C) and the proposed rule use the term ''excepted company'' to refer to section 3(c)(1) and section 3(c)(7) funds. The inclusion of section 3(c)(7) funds in this provision was presumably designed to require the consent to be obtained by any Grandfathered Fund that wished to be a qualified purchaser.

[84] *Id.*

[85] The legislative history of the 1996 Act does not address the purpose of the consent provision.

[86] Such conduct may also raise issues under section 48(a) of the Investment Company Act [15 U.S.C. 80a–47(a)] (precluding indirect circumvention of the Act's provisions).

[87] The following example illustrates the intended operation of the proposed rule. Assume Company A is a purchasing fund and that Companies B and C are beneficial owners of Company A's voting securities. Company B is an operating company that does not have a control relationship with Company A, but whose security holders were deemed to be beneficial owners of Company A's voting securities on October 11, 1996. Company C is a private fund that was deemed to own beneficially Company A's voting securities on October 11, 1996 (in other words, the look-through provision did not apply). Each of Company C's investors (Companies D through F) are themselves private funds, but none has a control relationship with Company C or Company A.

Company B would have to consent to Company A being a qualified purchaser. Because Company B is not a private fund, Company B's shareholders would not be treated as beneficial owners of Company A's voting securities, and their consent would not be required. (The consent of Company B's shareholders would not be required even if Company B had a control relationship with Company A.)

Company C would have to consent to Company A being a qualified purchaser. Additionally, because Company C is a private fund, all beneficial owners of its outstanding securities also would have to consent to Company A being a qualified purchaser. Because there is no control relationship, however, security holders of Companies D through F would not be required to consent even if they are considered to be beneficial owners of Company C's securities under the look-through provision. Similarly, Companies D through F would not be deemed to indirectly own voting securities of Company A.

defining indirect beneficial ownership in the purchasing fund on the basis of whether the investor has a control relationship with the purchasing fund or the target fund.

C. Conforming Rule

The Commission is proposing a rule to clarify an interpretative issue concerning companies that are qualified purchasers.[88] The statutory definition of qualified purchaser specifies that a trust that is a qualified purchaser must not have been formed ''for the specific purpose of acquiring the securities offered.'' [89] The proposed rule would make the same condition applicable to any other company that is a prospective qualified purchaser (whether a Family Company or another type of company) unless each beneficial owner of the company's securities or other interest in the company is a qualified purchaser. The proposed rule would limit the possibility that a company will be able to do indirectly what it is prohibited from doing directly (*i.e.*, organize a ''qualified purchaser'' entity for the purpose of making an investment in a particular section 3(c)(7) fund available to investors that themselves did not meet the definition of qualified purchaser).[90]

D. Non-Exclusive Safe Harbor for Certain Section 3(c)(7) Funds

The legislative history of the 1996 Act indicates that the grandfather provision is not intended to allow a sponsor of an existing section 3(c)(1) fund nominally to convert that fund into a section 3(c)(7) fund in order to create another section 3(c)(1) fund and thereby avoid the 100-investor limit.[91] While the 1996 Act includes a provision allowing a sponsor to operate both a section 3(c)(1) and a section 3(c)(7) fund (the ''non-integration provision''),[92] this provision was not designed to address whether a nominally converted section 3(c)(1) fund should be treated as a section 3(c)(7) fund for purposes of the integration and other applicable provisions.[93]

Since the passage of the 1996 Act, representatives of hedge funds and other investment pools have raised concerns regarding the ability of a sponsor of a section 3(c)(1) fund that undergoes a bona fide conversion into a section 3(c)(7) fund (*i.e.*, sells its securities to new investors that are qualified purchasers) to then create a new section 3(c)(1) fund. These representatives have requested that the Commission clarify the application of the non-integration provision to sponsors of Grandfathered Funds who form new section 3(c)(1) funds. To respond to these concerns, the Commission is proposing rule 3c–7 under the Investment Company Act to provide that a Grandfathered Fund will be treated as an issuer excepted under section 3(c)(7) of the Act if, at the time the new section 3(c)(1) fund offers its securities, 25% or more of the value of all securities of the Grandfathered Fund is held by qualified purchasers that acquired these securities after October 11, 1996. The proposed rule is designed to provide a non-exclusive safe harbor for Grandfathered Funds. Comment is requested whether the percentage threshold should be higher (*e.g.*, 50%). Comment also is requested whether existing investors that are qualified purchasers on the date that the Grandfathered Fund avails itself of section 3(c)(7) should also be counted for purposes of the proposed threshold.

III. Other Rules for Private Investment Companies

A. Transition Rule for Section 3(c)(1) Funds

As noted above, the 1996 Act amended section 3(c)(1)(A) of the Investment Company Act, which governs the way a section 3(c)(1) fund calculates the number of its beneficial owners for purposes of complying with the 100-investor limit. Under amended section 3(c)(1)(A), a section 3(c)(1) fund must include among its beneficial owners the underlying security holders of any investment company and any private fund that owns 10% or more of the section 3(c)(1) fund (collectively, ''10%+ investors''). Until the amendment becomes effective, the look-through provision does not apply unless the 10%+ investor also has more than 10% of its assets invested in section 3(c)(1) funds generally. The amendment, in effect, will limit the ability of certain types of investors to own more than 10% of a section 3(c)(1) fund.[94]

The Commission is aware that some existing section 3(c)(1) funds may have 10%+ investors in reliance on the pre-amendment application of the look-through provision. The Commission believes that the amendment to the look-through provision was primarily designed to simplify the application of the provision and was not intended to disrupt existing investment relationships. The Commission, therefore, is proposing a rule under the Investment Company Act to provide that the amended look-through provision will not apply in the case of an investor that held more than 10% of the outstanding voting securities of a section 3(c)(1) fund on October 11, 1996, provided that the investor continues to satisfy the second 10% test.[95]

The Commission requests comment on the approach of the proposed rule. For example, the proposed rule would not limit additional investments by the 10%+ investors in the section 3(c)(1) fund as long as the second 10% test continues to be inapplicable. Should the rule prohibit additional investments? Should the rule only permit additional investments that do not increase the percentage of the section 3(c)(1) fund's voting securities that the 10%+ investor owns? Are there other circumstances when similar relief would be appropriate?

Comment also is requested on rule 3c–2 under the Investment Company Act, which was adopted in 1958 to facilitate capital investments by operating companies in small business investment companies (''SBICs'') that were section 3(c)(1) funds.[96] Rule 3c–2

[88] Proposed rule 2a51–3.

[89] 15 U.S.C. 80a–2(a)(51)(A)(iii).

[90] *See supra* note 86 and accompanying text.

[91] *See* Remarks of Hon. John D. Dingell, *supra* note 11.

[92] Section 3(c)(7)(E) of the Investment Company Act [15 U.S.C. 80a–3(c)(7)(E)]. The non-integration provision states, in part, that an issuer that is otherwise excepted under section 3(c)(7) and an issuer that is otherwise excepted under section 3(c)(1) is not to be treated by the Commission as being a single issuer for purposes of determining the number of beneficial owners of the section 3(c)(1) fund or whether the outstanding securities of the section 3(c)(7) fund are owned by anyone who is not a qualified purchaser.

[93] *See* Remarks of Hon. John D. Dingell, *supra* note 11. The bona fides of a conversion to a section 3(c)(7) fund also would affect the ability of the fund to use the new exemption from the prohibition in the Investment Advisers Act of 1940 (''Advisers Act'') on performance fees available to section 3(c)(7) funds. *See* new section 205(b)(4) of the Advisers Act [15 U.S.C. 80b–5(b)(4)].

[94] The limitation will exist only when an investment company or a private fund invests in a section 3(c)(1) fund. The 1996 Act expands the ability of corporate, non-investment company investors to participate in section 3(c)(1) funds by no longer requiring section 3(c)(1) funds to count the underlying shareholders of these investors under any circumstances.

[95] Proposed rule 3c–1. For the purpose of the proposed rule, investment in section 3(c)(7) funds would be included in applying the second 10% test, since a section 3(c)(7) fund probably would have been a section 3(c)(1) fund but for the new exception created by the 1996 Act. The proposed rule also would address 10%+ ownership interests that result from voting securities acquired as a result of the conversion of convertible non-voting securities acquired prior to October 11, 1996.

[96] Rule 3c–2 [17 CFR 270.3c–2]. At that time, the look-through provision did not include the second 10% test and, therefore, inhibited SBICs' capital raising efforts because SBICs frequently depended upon corporate investors to make investments that resulted in their owning more than 10% of the SBICs voting securities.

provides that beneficial ownership of 10% or more of an SBIC's voting securities by a company is deemed to be ownership by one person if and so long as that company's total investment interest in all SBICs does not exceed 5% of the value of the company's assets. The amendments to the look-through provision made by the 1996 Act will make it unnecessary for an investor in an SBIC that is itself not an investment company or a private fund to rely on rule 3c–2.[97] Comment is requested whether rule 3c–2 is still necessary.[98] To what extent do SBICs rely on registered or private investment companies as a source of capital? To assure that the flow of capital to small businesses is not inhibited, should the rule be amended to incorporate the second 10% test? Should the rule be rescinded to reflect Congress' decision to eliminate the second 10% test?

B. Investments by Fund Employees

The Commission is proposing rule 3c–5 under the Investment Company Act to permit directors, executive officers, general partners and certain knowledgeable employees of a section 3(c)(1) fund or of an affiliated person of the fund (collectively, ''fund personnel'') to acquire securities issued by the fund without being counted for purposes of section 3(c)(1)'s 100-investor limit. The rule also would permit fund personnel to invest in a section 3(c)(7) fund even though they did not meet the definition of qualified purchaser.

The provision in the 1996 Act directing Commission rulemaking with regard to investments in private funds by knowledgeable employees appears to be intended to encompass all natural persons who actively participate in the management of a fund's investments. The proposed rule, therefore, would extend to directors, executive officers, and general partners of a fund or of an affiliate of the fund that oversees the fund's investments. The proposed rule also would extend to other employees who, in connection with their regular functions or duties, participated in, or obtained information regarding, the investment activities of the fund or other investment companies managed by the affiliate for a period of at least 12 months.[99] Comment is requested whether the proposed rule should contain any other criteria for identifying knowledgeable employees (*i.e.*, the employee's salary level or the amount of investments owned).

The proposed rule would allow transfers of fund securities held by fund personnel to family members as a gift, bequest or pursuant to an agreement relating to legal separation or divorce, as well as to family trusts and similar family vehicles established by fund personnel for the exclusive benefit of family members and charitable organizations, provided fund securities had been acquired by fund personnel pursuant to, or are otherwise subject to, an arrangement prohibiting any other transfers of such shares.[100] The Commission believes that this approach would afford adequate flexibility for employees' estate planning and other financial goals, while assuring that the securities of the issuer were not transferred in a manner inconsistent with the rationale underlying sections 3(c)(1) and 3(c)(7).

The Commission recognizes that the proposed rule would not extend to employees performing certain other functions with respect to a fund, such as clerical, secretarial and other administrative personnel. Should the rule be extended to these employees (or employees of firms that provide such services) if, for example, the employees are assisted by an independent purchaser representative?[101] The Commission also requests comment whether the proposed rule should contain any other requirements, particularly with respect to investments that are made by fund personnel through plans that are subject to the Employee Retirement Income Security Act of 1974, as amended.

C. Certain Transfers

Section 3(c)(1)(B) of the Act provides that beneficial ownership of securities of a section 3(c)(1) fund by any person who acquires the securities as a result of a ''legal separation, divorce, death, or other involuntary event'' will be deemed to be beneficial ownership by the person from whom the transfer was made, pursuant to such rules and regulations as the Commission prescribes. This provision was designed to address situations in which section 3(c)(1)'s 100-investor limit is exceeded ''because of transfers which are neither within the issuer's control nor are voluntary on the part of the present beneficial owner.''[102]

The 1996 Act directed the Commission to prescribe rules to implement section 3(c)(1)(B). The Commission is proposing rule 3c–6 under the Investment Company Act to provide that beneficial ownership by a person (''transferee'') who acquired securities of a section 3(c)(1) fund pursuant to a gift, bequest, or an agreement relating to a legal separation or divorce or other involuntary event will be deemed to be beneficial ownership by the person from whom the transfer was made (''transferor''). The proposed rule would limit transferees to family members of the transferor, trusts or similar vehicles established by the transferor for the exclusive benefit of family members, and charitable organizations. The proposed rule also would provide that the securities of the section 3(c)(1) fund must have been acquired by the transferor pursuant to, or are otherwise subject to, an arrangement prohibiting any other transfers, except transfers back to the fund. The Commission believes that the proposed rule would afford sufficient flexibility to section 3(c)(1) funds and their investors consistent with the intent behind section 3(c)(1)(B).

Proposed rule 3c–6 also would address transfers of securities by qualified purchasers under section 3(c)(7)(A) of the Act. That section provides that securities of a section 3(c)(7) fund that are owned by persons who received them from a qualified purchaser as a gift or bequest, or when the transfer was caused by legal separation, divorce, death or other involuntary event, will be deemed to be owned by a qualified purchaser, subject to such rules as the Commission may prescribe. Proposed rule 3c–6 would permit transfers of securities of a section 3(c)(7) fund under essentially the same conditions as those proposed for transfers under section 3(c)(1)(B).

Comment is requested on the proposed rule governing transfers of private funds' securities. Should transfers of a section 3(c)(7) fund's securities be governed by different conditions than transfers of a section 3(c)(1) fund's securities, or be permitted in other types of situations as well?

[97] The need for SBICs to rely on rule 3c–2 may have diminished when the second 10% test was added to the look-through provision in 1980.

[98] Rule 3c–2 also provides that the look-through provision does not apply to 10%+ investors that are ''state development corporations,'' subject to certain conditions.

[99] The term ''employee'' as used in the proposed rule is intended also to encompass individuals who may be deemed independent contractors for tax purposes. *See, e.g.*, Cornish & Carey Commercial, Inc. (pub. avail. June 21, 1996).

[100] The securities could be sold back to the issuing fund or, in the case of securities issued by a section 3(c)(7) fund, other qualified purchasers.

[101] A similar concept of ''purchaser representative'' is found in Regulation D under the Securities Act that governs securities transactions exempted from registration under section 5 of that Act. *See* rule 501(h) under the Securities Act [17 CFR 230.501(h)].

[102] H.R. Rep. No. 1341, 96th Cong., 2d Sess. at 36 (1980).

Should the rule provide other examples of ''involuntary events''?

IV. General Request for Comment

Any interested persons wishing to submit written comments on the rules that are the subject of this Release, to suggest additional rules to address interpretative and other issues relating to private funds resulting from the 1996 Act, or to submit comments on other matters that might have an effect on the proposals contained in this Release, are requested to do so. In accordance with section 2(c) of the Investment Company Act, comment is requested regarding the effects of the proposed rules on efficiency, competition and capital formation.

V. Cost/Benefit Analysis

Consistent with legislative intent and the protection of investors, the proposed rules would benefit private funds and their investors in a number of ways. The proposed rules would: define certain terms necessary to effectuate the new exclusion from regulation under the Investment Company Act for section 3(c)(7) funds; enable section 3(c)(1) funds that wish to convert into section 3(c)(7) funds or become qualified purchasers to do so without being subject to unduly burdensome notice and consent requirements; enable knowledgeable employees of a private fund to invest in the fund without causing the fund to relinquish its exclusion from regulation under the Act; permit certain transfers of private fund securities; and address certain interpretative issues for private funds.

The Commission believes that the proposed rules would not impose any additional costs on private funds. Rather, the proposed rules would clarify the statutory requirements for private funds in order to reduce any unnecessary burdens without jeopardizing investor protection. Comment is requested on this cost/benefit analysis. Commenters are requested to provide views and empirical data relating to any costs and benefits associated with the proposed rules.

For purposes of making determinations required by the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is requesting information regarding the potential impact of the proposed rules on the economy on an annual basis. Commenters should provide empirical data to support their views.

VI. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 USC 603 regarding proposed rules 2a51–1, 2a51–2, 2a51–3, 3c–1, 3c–5, 3c–6 and 3c–7 under the Investment Company Act. The IRFA indicates that the proposed rules would comply with the provisions of the 1996 Act directing the Commission to prescribe certain rules concerning private funds, and would address certain interpretive issues raised by the 1996 Act's amendments relating to private funds. The IRFA states that the proposed rules, among other things, are designed to assure that investors in section 3(c)(7) funds are the types of investors that Congress determined do not need the protections of the Investment Company Act. The IRFA further states that the proposed rules would give private funds greater flexibility as well as minimize certain compliance burdens imposed by the applicable provisions of the Investment Company Act.

The IRFA sets forth the statutory authority for the proposed rules. The IRFA also discusses the effect of the proposed rules on small entities that are section 3(c)(7) or section 3(c)(1) funds. For purposes of the proposed rules, small entities are those with assets of $50 million or less at the end of their most recent fiscal year. The IRFA states that the proposed rules would make possible the creation of small entities that are section 3(c)(7) funds, and would provide greater flexibility and minimize certain compliance burdens imposed by the provisions of the Investment Company Act on small entities that are section 3(c)(1) funds. It is estimated that there are approximately 600 U.S. venture capital pools that are section 3(c)(1) funds, of which about 50% may be considered small entities. The number of U.S. hedge funds has been estimated as being between 800 and 3,000. Based on a sample of 250 hedge funds, it is estimated that approximately 75% may be small entities.

The IRFA states that the proposed rules would not impose any new reporting, recordkeeping or compliance requirements, and that the Commission believes that there are no rules that duplicate, overlap or conflict with the proposed rules.

The IRFA discusses the various alternatives considered by the Commission in connection with the proposed rules that might minimize the effect on small entities, including: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities; (b) the clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule or any part thereof, for small entities. The Commission believes that it would be inconsistent with the purposes of the Act to exempt small entities from the proposed rules or to use performance standards to specify different requirements for small entities. Different compliance or reporting requirements for small entities are not necessary because the proposed rules do not establish any new reporting, recordkeeping or compliance requirements. The Commission has determined that it is not feasible to further clarify, consolidate or simplify the proposed rules for small entities.

The IRFA includes information concerning the solicitation of comments with respect to the IRFA generally, and in particular, the number of small entities that would be affected by the proposed rules. Cost-benefit information reflected in the ''Cost/Benefit Analysis'' section of this Release also is reflected in the IRFA. A copy of the IRFA may be obtained by contacting David P. Mathews, Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop 10–2, Washington, D.C. 20549.

VII. Statutory Authority

The Commission is proposing rules 2a51–1, 2a51–2, 2a51–3 and 3c–7 pursuant to the authority set forth in sections 2(a)(51)(B), 6(c) and 38(a) of the Investment Company Act [15 USC 80a–2(a)(51)(B), –6(c) and –37(a)] and sections 209(d)(2) and (4) of the 1996 Act. The Commission is proposing rule 3c–1 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 USC 80a–6(c) and –37(a)]. The Commission is proposing rule 3c–5 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 USC 80a–6(c) and –37(a)] and section 209(d)(3) of the 1996 Act. The Commission is proposing rule 3c–6 pursuant to the authority set forth in sections 3(c)(1), 3(c)(7), 6(c) and 38(a) of the Investment Company Act [15 USC 80a–3(c)(1), 3(c)(7), 6(c) and –37(a)] and section 209(d)(1) of the 1996 Act.

Text of Proposed Rules

List of Subjects in 17 CFR Part 270

Investment companies, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the

Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 is amended by adding the following citations to read as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–37, 80a–39 unless otherwise noted;

* * * * *

Section 270.2a51–1 is also issued under 15 U.S.C. 80a–2(a)(51)(B) and 80a–6(c), and secs. 209(d) (2) and (4), National Securities Markets Improvement Act of 1996;

Section 270.2a51–2 is also issued under 15 U.S.C. 80a–2(a)(51)(B) and 80a–6(c), and secs. 209(d) (2) and (4), National Securities Markets Improvement Act of 1996;

Section 270.2a51–3 is also issued under 15 U.S.C. 80a–2(a)(51)(B) and 80a–6(c), and secs. 209(d) (2) and (4), National Securities Markets Improvement Act of 1996;

Section 270.3c–1 is also issued under 15 U.S.C. 80a–6(c);

Section 270.3c–5 is also issued under 15 U.S.C. 80a–6(c), and sec. 209(d)(3), National Securities Markets Improvement Act of 1996;

Section 270.3c–6 is also issued under 15 U.S.C. 80a–3(c)(1), 80a–3(c)(7), 80a–6(c) and 80a–37(a) and sec. 209(d)(1), National Securities Markets Improvement Act of 1996;

Section 270.3c–7 is also issued under 15 U.S.C. 80a–2(a)(51)(B) and 80a–6(c);

* * * * *

2. Section 270.2a51–1 is added to read as follows:

§ 270.2a51–1 Definition of investments for purposes of section 2(a)(51) (definition of ''qualified purchaser''); certain calculations.

(a) *Definitions.* As used in this section:

(1) The term *Commodity Interests* shall mean commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of:

(i) Any contract market designated for trading such transactions under the Commodity Exchange Act and the rules thereunder; or

(ii) Any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules under the Commodity Exchange Act [17 CFR 30];

(2) The term *Family Company* shall mean a company described in paragraph (A)(ii) of section 2(a)(51) of the Act [15 U.S.C. 80a–2(a)(51)];

(3) The term *Listed Company* shall mean a company that has outstanding a class of equity securities that are:

(i) Reported securities as such term is defined by § 240.11Aa3–1 of this Chapter; or

(ii) Listed on a ''designated offshore securities market'' as such term is defined by Regulation S under the Securities Act of 1933 [17 CFR 230.901 through 230.904];

(4) The term *Physical Commodities* shall mean any physical commodity with respect to which a Commodity Interest is traded on a market specified in paragraphs (a)(1) of this section; and

(5) The term *Related Person* shall mean a person who is related to another person as a sibling, spouse or former spouse, or is a direct lineal descendant or ancestor by birth or adoption of such person, or is a spouse of such descendant, *provided that*, in the case of a Family Company, a Related Person includes any owner of the Family Company and any person who is a Related Person of such owner.

(b) *Types of Investments.* For purposes of section 2(a)(51) of the Act [15 U.S.C. 80a–2(a)(51)], the term *investments* shall mean:

(1) Securities (as defined by section 2(1) of the Securities Act of 1933 [15 U.S.C. 70a(1)]), other than securities of an issuer that controls, is controlled by, or is under common control with, the person that owns such securities, unless the issuer is:

(i) An investment company or a company that would be an investment company but for the exclusions provided by sections 3(c)(1) through 3(c)(9) of the Act [15 U.S.C. 80a–3(c)(1) through 3(c)(9)] or the exemptions provided by §§ 270.3a–6 or 270.3a–7; or

(ii) A Listed Company that is not a majority-owned subsidiary of such person or a person that controls, is controlled by, or is under common control with such person;

(2) Real estate held for investment purposes;

(3) Commodity Interests held for investment purposes;

(4) Physical Commodities held for investment purposes; and

(5) Cash and cash equivalents held for investment purposes.

(c) *Real Estate Not Held for Investment Purposes.* For purposes of this section, real estate shall not be considered to be held for investment purposes by its owner if it is used by the owner or a Related Person of the owner for personal purposes or as a place of business, or in connection with the conduct of the trade or business of such owner or a Related Person of the owner. Residential real estate shall not be deemed to be used for personal purposes if deductions with respect to such real estate are not disallowed by section 280A of the Internal Revenue Code [26 USC 280A].

(d) *Valuation.* For purposes of determining whether a person is a qualified purchaser, the aggregate amount of investments owned and invested on a discretionary basis by such person shall be their readily ascertainable market value on the most recent practicable date or their cost, *provided that*:

(1) In the case of Commodity Interests, the amount of investments shall be the value of the initial margin or option premium deposited in connection with such Commodity Interests; and

(2) In each case, there shall be deducted from the amount of investments owned by such person the amounts specified in paragraphs (e), (f) and (g) of this section, as applicable.

(e) *Deductions: General.* In determining whether any person is a qualified purchaser there shall be deducted from the value of such person's investments the amount of any outstanding indebtedness incurred to acquire the investments owned by such person.

(f) *Deductions: Natural Persons.* In determining whether any natural person is a qualified purchaser, in addition to the amounts specified in paragraph (e) of this section there shall also be deducted from the value of such person's investments the following amounts:

(1) Any payments received by such person pursuant to an insurance policy during the preceding 12 months;

(2) The value of any investments received by such person during the preceding 12 months as a gift or bequest or pursuant to an agreement related to a legal separation or divorce;

(3) Any amount received by such person during the preceding 12 months in connection with a lawsuit (whether pursuant to a judgment or settlement agreement);

(4) The proceeds of any loan incurred during the preceding 12 months secured by a mortgage or deed of trust on such person's personal residence or other property that is not held for investment (''mortgage loan'') unless the proceeds of such loan were used solely to finance the acquisition or improvement of such residence or property; and

(5) The proceeds of any loan (''refinancing loan'') incurred during the preceding 12 months secured by a mortgage or deed of trust on such person's personal residence or other property that is not held for investment used to refinance a mortgage loan (''refinanced loan'') to the extent that the proceeds of the refinancing loan exceed the lowest principal amount of the refinanced loan outstanding during the prior 12 months.

(g) *Deductions: Family Companies.* In determining whether a Family Company is a qualified purchaser, in addition to

the amounts specified in paragraph (e) of this section, there shall also be deducted from the value of such Family Company's investments the following amounts for purposes of this section:

(1) Any outstanding indebtedness incurred by an owner of the Family Company to acquire such investments;

(2) The amounts described in paragraph (f) of this section received by the Family Company or any owner of the Family Company;

(3) The amount of any indebtedness incurred by the Family Company to the extent that the principal amount of such indebtedness exceeds the fair market value of any assets of the Family Company other than investments; and

(4) The amount of any indebtedness incurred by an owner of the Family Company or by a Related Person of an owner of the Family Company and guaranteed by the Family Company.

(h) *Joint Investments.* In determining whether a natural person is a qualified purchaser, there may be included in the value of such person's investments any investments held jointly with such person's spouse, or investments in which such person shares with such person's spouse a community property or similar shared ownership interest. There shall be deducted from the amount of any such investments any amounts specified by paragraphs (e) and (f) of this section incurred or received by such spouse.

(i) *Corporate Investments.* For purposes of determining the amount of investments owned by a corporation (''Corporation'') under section 2(a)(51)(A)(iv) of the Act [15 U.S.C. 80a–2(a)(51)(A)(iv)], there may be included investments owned by majority-owned subsidiaries of the Corporation (''Subsidiaries''), provided that the investments of the Subsidiary are managed under the direction of the Corporation.

(j) *Good Faith Reliance.* In determining whether a prospective purchaser is a qualified purchaser, an issuer or a person acting on the issuer's behalf (collectively, ''relying person'') shall be entitled to rely upon audited financial statements, brokerage account statements and other appropriate information and certifications provided by the prospective purchaser or its representatives and dated as of a recent date, or publicly available information as of a recent date, provided that such reliance is reasonable and the relying person, after reasonable inquiry, does not have any basis for believing that such information is incorrect in any material respect.

3. Section 270.2a51–2 is added to read as follows:

§ 270.2a51–2 Definitions of beneficial owner for certain purposes under sections 2(a)(51) and 3(c)(7) and determining indirect ownership interests.

(a) Except as set forth below, for purposes of sections 2(a)(51)(C) and 3(c)(7)(B)(ii) of the Act [15 U.S.C. 80a–2(a)(51)(C) and 3(c)(7)(B)(ii)], the beneficial owners of securities of an excepted investment company (as defined in section 2(a)(51)(C) of the Act [15 U.S.C. 80a–2(a)(51)(C)]) shall be determined in accordance with section 3(c)(1) of the Act [15 U.S.C. 80a–3(c)(1)].

(b) For purposes of section 3(c)(7)(B)(ii) of the Act [15 U.S.C. 80a–3(c)(7)(B)(ii)], securities of an issuer beneficially owned by a company (without giving effect to section 3(c)(1)(A) of the Act [15 U.S.C. 80a–3(c)(1)(A)]) (''owning company'') shall be deemed to be beneficially owned by one person unless:

(1) The owning company is an investment company or an excepted investment company;

(2) The owning company, directly or indirectly, controls, is controlled by, or is under common control with, the issuer; and

(3) On October 11, 1996, under section 3(c)(1)(A) of the Act as then in effect, the voting securities of the issuer were deemed to be beneficially owned by the holders of the owning company's outstanding securities (other than short-term paper), in which case, such holders shall be deemed to be beneficial owners of the issuer's outstanding voting securities.

(c) For purposes of section 2(a)(51)(C) of the Act [15 U.S.C. 80a–2(a)(51)(C)], securities of an excepted investment company beneficially owned by a company (without giving effect to section 3(c)(1)(A) of the Act [15 U.S.C. 80a–3(c)(1)(A)]) (''owning company'') shall be deemed to be beneficially owned by one person unless:

(1) The owning company is an excepted investment company;

(2) The owning company directly or indirectly controls, is controlled by, or is under common control with, the excepted investment company or the company with respect to which the excepted investment company is, or will be, a qualified purchaser; and

(3) On April 30, 1996, under section 3(c)(1)(A) of the Act as then in effect, the voting securities of the excepted investment company were deemed to be beneficially owned by the holders of the owning company's outstanding securities (other than short-term paper), in which case the holders of such excepted company's securities shall be deemed to be beneficial owners of the excepted investment company's outstanding voting securities.

(d) For purposes of section 2(a)(51)(C) of the Act [15 U.S.C. 80a–2(a)(51)(C)], an excepted investment company shall not be deemed to indirectly own the securities of an excepted investment company seeking a consent to be treated as a qualified purchaser (''qualified purchaser company'') unless such excepted investment company, directly or indirectly, controls, is controlled by, or is under common control with, the qualified purchaser company or a company with respect to which the qualified purchaser company is or will be a qualified purchaser.

Note to § 270.2a51–2. On October 11, 1996, the National Securities Markets Improvement Act of 1996 [P.L. 104–290] was signed into law. Prior to that date, section 3(c)(1)(A) of the Act provided that: (A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if the company owns 10 per centum or more of the outstanding voting securities of the issuer, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper) unless, as of the date of the most recent acquisition by such company of securities of that issuer, the value of all securities owned by such company of all issuers which are or would, but for the exception set forth in this subparagraph, be excluded from the definition of investment company solely by this paragraph, does not exceed 10 per centum of the value of the company's total assets. Such issuer nonetheless is deemed to be an investment company for purposes of section 12(d)(1).

4. Section 270.2a51–3 is added to read as follows:

§ 270.2a51–3 Certain companies not qualified purchasers.

For purposes of section 2(a)(51)(A) (ii) and (iv) of the Act [15 U.S.C. 80a–2(a)(51)(A)] a company shall not be deemed to be a qualified purchaser if it was formed for the specific purpose of acquiring the securities offered by a company excluded from the definition of investment company by section 3(c)(7) of the Act [15 U.S.C. 80a–3(c)(7)] unless each beneficial owner of the company's securities or other interest in the company is a qualified purchaser.

5. Section 270.3c–1 is added to read as follows:

§ 270.3c–1 Definition of beneficial ownership for certain private investment companies.

(a) As used in this section:

(1) The term *Covered Company* shall mean a company that is an investment company, a Section 3(c)(1) Company or a Section 3(c)(7) Company.

(2) The term *Section 3(c)(1) Company* shall mean a company that would be an

investment company but for the exclusion provided by section 3(c)(1) of the Act [15 U.S.C. 80a–3(c)(1)].

(3) The term *Section 3(c)(7) Company* shall mean a company that would be an investment company but for the exclusion provided by section 3(c)(7) of the Act [15 U.S.C. 80a–3(c)(7)].

(b) For purposes of section 3(c)(1)(A) of the Act [15 U.S.C. 80a–3(c)(1)(A)], beneficial ownership by a Covered Company owning 10 percent or more of the outstanding voting securities of a Section 3(c)(1) Company shall be deemed to be beneficial ownership by one person, *provided that:*

(1) On October 11, 1996, the Covered Company owned 10 percent or more of the outstanding voting securities of the Section 3(c)(1) Company or non-voting securities that, on such date and in accordance with the terms of such securities, were convertible into or exchangeable for voting securities that, if converted or exchanged on or after such date, would have constituted 10 percent or more of the outstanding voting securities of the Section 3(c)(1) Company; and

(2) On the date of any acquisition of securities of the Section 3(c)(1) Company by the Covered Company, the value of all securities owned by the Covered Company of all issuers that are Section 3(c)(1) or Section 3(c)(7) Companies does not exceed 10 percent of the value of the Covered Company's total assets.

6. Section 270.3c–5 is added to read as follows:

§ 270.3c–5 Beneficial ownership by knowledgeable employees and certain other persons.

(a) As used in this section:

(1) The term *Covered Company* shall mean a company that is an investment company, a Section 3(c)(1) Company or a Section 3(c)(7) Company.

(2) The term *Executive Officer* shall mean the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for a Covered Company.

(3) The term *Knowledgeable Employee* with respect to any Covered Company shall mean any natural person who is:

(i) An Executive Officer, director, or general partner of the Covered Company or of an affiliated person of such Covered Company that manages the investment activities of such Covered Company; or

(ii) An employee of the Covered Company or of an affiliated person of such Covered Company that manages the investment activities of such Covered Company (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in, or obtains information regarding, the investment activities of such Covered Company or other investment companies the investment activities of which are managed by such affiliated person, *provided that* such employee has been performing such functions and duties for or on behalf of the Covered Company or the affiliated person of the Covered Company for at least 12 months.

(4) The term *Related Person* shall mean a person who:

(i) Is related to another person as a sibling, spouse or former spouse; or

(ii) Is a direct lineal descendant or ancestor by birth or adoption of such person, or is a spouse of such descendant.

(5) The term *Section 3(c)(7) Company* shall mean a company that would be an investment company but for the exclusion provided by section 3(c)(7) of the Act [15 U.S.C. 80a–3(c)(7)].

(6) The term *Section 3(c)(1) Company* shall mean a company that would be an investment company but for the exclusion provided by section 3(c)(1) of the Act [15 U.S.C. 80a–3(c)(1)].

(b) For purposes of determining the number of beneficial owners of a Section 3(c)(1) Company, and whether the outstanding securities of a Section 3(c)(7) Company are owned exclusively by qualified purchasers, there shall be excluded securities beneficially owned by a Knowledgeable Employee of such Company; an estate of such Knowledgeable Employee; a Related Person of such Knowledgeable Employee who acquired such securities as a gift, bequest or pursuant to an agreement relating to a legal separation or divorce; or a company established by the Knowledgeable Employee exclusively for the benefit of (or owned exclusively by) the Knowledgeable Employee, his or her estate, and his or her Related Persons or charitable organizations, *provided, however,* that in each case such securities shall have been acquired by the Knowledgeable Employee pursuant to, or shall otherwise be subject to, an arrangement that prohibits the transfer, pledge or hypothecation of such securities, or any interest in such securities, to any person other than the Covered Company, such estate, such Related Persons, such companies or, if the Covered Company is a Section 3(c)(7) Company, qualified purchasers.

7. Section 270.3c–6 is added to read as follows:

§ 270.3c–6 Certain transfers of interests in section 3(c)(1) and section 3(c)(7) funds.

(a) As used in this section:

(1) The term *Related Person* shall mean a person who is:

(i) Related to another person as a sibling, spouse or former spouse; or

(ii) A direct lineal descendant or ancestor by birth or adoption of such person, or is a spouse of such descendant.

(2) The term *Section 3(c)(7) Company* shall mean a company that would be an investment company but for the exclusion provided by section 3(c)(7) of the Act [15 U.S.C. 80a–3(c)(7)].

(3) The term *Section 3(c)(1) Company* shall mean a company that would be an investment company but for the exclusion provided by section 3(c)(1) of the Act [15 U.S.C. 80a–3(c)(1)].

(4) The term *Transferee* shall mean a Section 3(c)(1) Transferee or a Qualified Purchaser Transferee in each case as defined in paragraph (b) of this section.

(5) The term *Transferor* shall mean a Section 3(c)(1) Transferor or a Qualified Purchaser Transferor in each case as defined in paragraph (b) of this section.

(b) Beneficial ownership by any person (''Section 3(c)(1) Transferee'') who acquires securities or interests in securities of a Section 3(c)(1) Company shall be deemed to be beneficial ownership by the person from whom such transfer was made (''Section 3(c)(1) Transferor''), and securities of a Section 3(c)(7) Company that are owned by persons who received the securities from a qualified purchaser (''Qualified Purchaser Transferor'') shall be deemed to be owned by a qualified purchaser (''Qualified Purchaser Transferee''), *provided that:*

(1) The transfer was made as a gift or bequest, or pursuant to an agreement relating to a legal separation or divorce or as a result of another involuntary event;

(2) The Transferee is:

(i) The estate of the Transferor;

(ii) A Related Person of the Transferor; or

(iii) A company established by the Transferor exclusively for the benefit of (or owned exclusively by) his or her estate, Related Persons or charitable organizations; and

(3) The securities shall have been acquired by the Transferor pursuant to, or shall otherwise be subject to, an arrangement that prohibits the transfer, pledge or hypothecation of such securities, or any interest in such

securities, to any person other than the Company that issued the securities, the Transferor's estate, such Related Persons or such companies or, in the case of a Qualified Purchaser Transferor, qualified purchasers.

8. Section 270.3c–7 is added to read as follows:

§ 270.3c–7 Non-exclusive safe harbor for certain section 3(c)(7) funds.

An issuer relying on section 3(c)(7)(B) of the Act [15 U.S.C. 80a–3(c)(7)(B)] shall be deemed to be excluded under section 3(c)(7) of the Act [15 U.S.C. 80a–3(c)(7)] if 25% or more of the value of the issuer's securities is held by qualified purchasers that acquired these securities after October 11, 1996.

Dated: December 18, 1996.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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